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No. 197

In the Supreme Court of the United States

OCTOBER TERM, 1945

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ANNA VICKERS CRAWFORD

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 103–112) is unreported. The opinion of the Circuit Court of Appeals (R. 131–133) is reported at 148 F. 2d 776.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 21, 1945 (R. 133). The petition for a writ of certiorari was filed on July 3, 1945, and was granted on October 8, 1945, the case being set to follow *Kirby Petroleum Co.* v. *Commissioner,* No. 56, this Term (R. 134). The

jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer was the owner of an undivided one-third interest in certain property containing oil and gas deposits. She entered into several leases whereby the lessees became obligated to pay to the taxpayer royalty payments, *i. e.*, a share of the production of oil and gas or its gross proceeds, and also a share of the net profits derived from the oil and gas produced.

The question is whether the Circuit Court of Appeals erred in holding that the taxpayer was entitled, under Sections 23 (m) and 114 (b) (3) of the Revenue Act of 1938 and of the Internal Revenue Code, to a depletion deduction on the portion of the net profits received by her.

STATUTES AND REGULATIONS INVOLVED

The relevant provisions of the statutes and regulations involved are set forth in the Appendix, *infra*, pp. 12–16.

STATEMENT

The facts in this case were stipulated by the parties and the Tax Court found the facts as stipulated (R. 26–100, 103).

The taxpayer is an individual residing in Los Angeles, California. Her tax returns for each of the taxable years in question were filed with

the Collector of Internal Revenue for the Sixth District of California (R. 26, 103).

The taxpayer owned an undivided one-third interest in certain real property situated in the County of Los Angeles, California (R. 27, 104). On April 12, 1924, taxpayer, together with the owners of the remaining interests in the property, executed a lease with the Standard Oil Company, a California corporation, as lessee, for the drilling of oil on a portion of the property (R. 27, 104). The lessee was granted "the sole and exclusive right to drill for, produce, extract and take oil, gas, asphaltum and other hydrocarbon substances" from the property (R. 33). These exclusive drilling and operating rights were granted for two years and for so long thereafter as the lessee should conduct drilling operations and so long as oil and gas were produced in paying quantities (R. 33, 104).

The lessee paid $75,000 at the time of the execution of the lease and agreed to commence the drilling of a well within two years and to continue with reasonable diligence until oil was found in paying quantities (R. 33–34, 104). At any time within two years, the lessee could terminate the lease and surrender the premises; however, if oil were discovered on adjoining property during the first twenty-one months of the lease, the lessee was obligated to commence the drilling of a well within three months or terminate the lease (R. 34, 104–105). If the

lessee had not commenced the drilling of a well within one year after execution of the lease, it was obligated to pay $10 per month per acre or to terminate the lease (R. 35, 105). If the lessee failed to obtain oil in paying quantities from the first well, it was required to commence the drilling of another well within ninety days in order to retain its rights under the agreement (R. 36, 105).

If oil was found in paying quantities, additional wells were to be drilled as rapidly as at least two strings of tools working with due diligence could complete them until a specified number of wells had been drilled (R. 36–37, 105). After completion of the first or any subsequent well, the lessee could cease further drillings, surrender the premises and terminate the agreement, except as to ten acres around each producing or drilling well which could be held free of further drilling obligations so long as oil or gas was produced therefrom (R. 37, 105). The lessee also agreed to commence drilling offset wells within ninety days after discovery of oil within 250 feet of the boundary lines of the property (R. 37–38, 105).

All labor and materials were to be furnished by the lessee (R. 41, 105). The lessee agreed to pay "any and all taxes assessed upon the mineral rights in said premises," as well as the taxes levied against the oil and minerals stored on the premises and against the property and equipment owned by it and located on the property (R. 39).

Paragraph 31 of the lease provided that the lessee should pay to the lessors (R. 45):

> A. As a minimum:
>
> (1) A sum representing the "sale value" as herein defined of the one-fifth (⅕th) part of all oil, asphaltum and other hydrocarbon substances, other than gas, extracted and saved from the said premises during the preceding calendar month.
>
> (2) One-fifth (⅕th) of the actual proceeds of all gas produced and saved and sold off the premises by second party during such preceding calendar month.
>
> (B) Such sum, if any, in addition, as shall represent the amount by which one-half (½) of the "net profits" derived from the operations on said property up to the end of such calendar month shall exceed the aggregate of—
>
> (1) All sums theretofore paid to first parties by second party pursuant to the provisions of this paragraph (31), plus
>
> (2) The amount contemporaneously payable by second party to first parties pursuant to the provisions of Subdivision A of this paragraph.

The terms "sale value" and "net profits" were defined by the agreement (R. 42–44). If the lessee failed for ninety days after written notice to comply with any provisions of the lease, the lessors had the right to terminate the agreement, except that default as to any well or wells would not affect the lessee's operation of any other well

or wells situated in any other ten acre parcel (R. 46, 107).

On January 6, 1925, the lessors entered into another agreement with the same lessee for the drilling of oil on a different portion of the property. The lease was for a term of five years and so long thereafter as oil and gas were produced in paying quantities unless otherwise surrendered or forfeited by the lessee (R. 52, 107). The provisions of the agreement were substantially the same as those of the first lease between the same parties (R. 49–64, 107). The consideration was different in that $80,000 was paid by the lessee concurrently with the execution of the lease (R. 52–53, 107) and the minimum monthly sum to be paid was one-sixth of the "sale value" of the oil, asphaltum and other hydrocarbon substances extracted and one-sixth of the actual proceeds of the gas produced, saved and sold off the premises (R. 63, 107). The provisions for the payment of one-half of the "net profits" were the same as the provisions of paragraph 31B of the prior agreement (R. 63, 107).

On April 18, 1924, the lessors executed another lease with the Associated Oil Company, a California corporation, for drilling of oil on another portion of the same property. The property covered 101 acres, more or less, and was leased for a term of twenty years (R. 66–96, 107–108).

The lessee agreed to pay $500 per acre for the privilege of drilling and an oil bonus of $500 per

acre to be paid monthly at the rate of one-sixth of the net production until paid (R. 70–71, 108). The lessors were also entitled to a "primary royalty" of one-sixth of the net amount of all petroleum, oil, naphtha and other hydrocarbon substances produced and saved from the property after deducting from the gross product the quantity consumed in the development and operation of the property, and of one-sixth of the proceeds derived from the sale of all gas produced from the property (R. 80, 108). The lessee could contract for the manufacture of casinghead gasoline from gas produced on the premises, provided that at least 35 percent was to be reserved and to be divided, one-sixth to the lessors and five-sixths to the lessee (R. 80–81, 108).

The lessors were entitled, in addition, to receive a "secondary royalty," the agreement providing (R. 84):

> When, and as soon as the "Income Credits" of said account shall exceed the "Operating Charges" of the Lessee, the Lessor shall be entitled to a secondary and additional royalty, the amount thereof to be one-half of such difference between the "Operating Charges ["] and "Income Credits" of said account.

Paragraph 23 of the agreement defined the terms "Income Credits" and "Operating Charges" (R. 81–84) in such a manner that the difference between the two sums was comparable

to the term "net profits" as used in the leases between the lessors and the Standard Oil Company.

The lease contained provisions for surrender by the lessee, or for termination by the lessors in the event that the lessee failed to comply with the provisions of the agreement (R. 91–93, 109). The lease specifically provided that upon termination of the lessee's rights "the title to all unsevered petroleum, oil, natural gas, and other hydrocarbon substances lying in and under the demised premises shall revert to the respective owners thereof * * *" (R. 91).

During the taxable years in question all three leases were in effect. During the years 1938, 1939, and 1940, taxpayer received, pursuant to paragraphs 31A of the Standard Oil leases, gross income from primary royalties in the aggregate respective amounts of $50,321.41, $45,771.09, and $39,534.63; during the same years taxpayer received, pursuant to paragraphs 31B of these leases (one-half of the net profits), the following respective amounts: $62,327.91, $52,693.39, and $44,506.39 (R. 28–29, 109–110).

During the same years taxpayer received primary royalties from Associated Oil Company, pursuant to paragraph 22 of that lease, in the respective amounts of $19,700.03, $20,275, and $20,958.88; during the same years she received secondary royalties (based on net profits), pur-

suant to paragraph 23 of the lease, in the respective amounts of $34,729.20, $34,883.54, and $39,941.02 (R. 29, 110).

In calculating her taxable income for the years in question, taxpayer deducted statutory depletion at the rate of 27½ percent of the respective amounts set forth above. The Commissioner determined deficiencies for income taxes for the years 1938, 1939 and 1940, resulting in part from his conclusion that taxpayer was not entitled to deduct depletion on the amounts received by her as a division of net profits and paid pursuant to paragraph 31B of the Standard Oil leases and paragraph 23 of the Associated Oil Company lease (R. 29–30, 103).

The taxpayer sought a redetermination of the deficiencies before the Tax Court. The Tax Court refused to uphold the Commissioner's determination in this respect, ruling that the taxpayer was entitled to a deduction for statutory depletion on all amounts received by her pursuant to the above-mentioned leases (R. 103–112). The Circuit Court of Appeals affirmed the decision of the Tax Court (R. 131–133).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred in holding that, under Sections 23 (m) and 114 (b) (3) of the Revenue Act of 1938 and of the Internal Revenue Code, the taxpayer was entitled to percentage depletion on the share of the lessees' net

profits paid to her, and in affirming the decision of the Tax Court.

SUMMARY OF ARGUMENT

The single deduction for depletion is apportionable between a lessor and a lessee only as each is entitled to share in the production of oil and gas, or the gross proceeds thereof. In this case the lessors retained the right to share in the production of oil and gas only to the extent that cash bonuses were received and to the extent that they were entitled to receive oil and gas royalties. The gross income from this portion of production represented the measure of the depletion deduction to be taken by the lessors. The additional right of the lessors to a part of the net profits earned by the lessees did not evidence a right to share in production, and the net profits received did not represent gross income from the property on which depletion is allowable. Except for the bonuses and royalties paid, all the remaining production was acquired by the lessees and they were entitled to the deduction for depletion on the gross income from that portion of the oil and gas.

The decision of the Tax Court permitting the taxpayer the deduction for depletion on the share of the net profits which she received from the lessees was not in accordance with law and the Circuit Court of Appeals erred in failing to reverse the Tax Court.

ARGUMENT

The reasons set forth in the Commissioner's brief in *Kirby Petroleum Co.* v. *Commissioner*, No. 56, this Term, for denying to the lessor in that case the deduction for depletion on the share of the lessees' net profits received, apply with equal force to this case and need not be reiterated. Accordingly, the Court is respectfully referred to the Commissioner's argument in that case for the reasons supporting his position that the court below erred in failing to reverse the decision of the Tax Court in the present case.

CONCLUSION

The judgment of the Circuit Court of Appeals is erroneous and should be reversed.

Respectfully submitted.

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OCTOBER 1945.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument

creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

* * * * *

(26 U. S. C. 23)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

* * * * *

(3) *Percentage Depletion For Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

(26 U. S. C. 114)

The provisions of Sections 23 (m) and 114 (b) (3) of the Revenue Act of 1938, c. 289, 52 Stat. 447, are identical.

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (m)-1 [as amended by T. D. 5413, 1944 Cum. Bull. 124]. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—Section 23 (m) provides that there

shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

* * * * *

(f) * * *

In the case of oil and gas wells, "gross income from the property" as used in section 114 (b) (3) means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. * * *

* * * * *

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property." If royalties in the form of bonus payments have been paid in respect of the property in the taxable year or any prior years or if advanced royalties have been paid in respect of the property in any taxable year ending prior to December 31, 1939, the amount excluded from "gross income from the property" for the current taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the product sold during the taxable year. If advanced royalties have been paid in respect of the property in any taxable year ending on or after December 31, 1939, the amount excluded from "gross income from the property" for the current taxable year on account of such payments shall be an amount equal to the deduction for such taxable year taken on account of such payments pursuant to section 19.23 (m)-10 (e).

* * * * *

SEC. 19.23 (m)-4. *Computation of depletion based on a percentage of income in the case of oil and gas wells.*—Under section 114 (b) (3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ percent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property"

and "net income of the taxpayer (computed without allowance for depletion) from the property," see paragraphs (f) and (g) of section 19.23 (m)-1.) In no case shall the deduction computed under this section be less than it would be if computed upon the cost or other basis of the property provided in section 113.

The provisions of Articles 23 (m)-1 and 23 (m)-4 of Treasury Regulations 101, promulgated under the Revenue Act of 1938, are substantially the same.

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